



University of Baltimore Law Review

Volume 4
Issue 2 Spring 1975

Article 5

1975

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Recommended Citation

Miller, Cleaveland D. (1975) "The Fiduciary Duties of a Corporate Director," *University of Baltimore Law Review*: Vol. 4: Iss. 2, Article 5.

Available at: <http://scholarworks.law.ubalt.edu/ublr/vol4/iss2/5>

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THE FIDUCIARY DUTIES OF A CORPORATE DIRECTOR

Cleaveland D. Miller†

The obligations of a director to the corporation and its stockholders are frequently unknown or confusing to an individual assuming such a position. The author discusses the director's exposure to liability and delineates the major areas of responsibility which determine a director's standard of performance.

The duties imposed upon a corporate director and the liabilities which follow a breach of those duties are issues which have continuously attracted the attention of legal writers and puzzled the courts. Rather than melding into a consistent approach to these issues, the divergence of viewpoints concerning a director's duties and liabilities has increased in recent years. Some commentators have suggested that knowledgeable and experienced directors will be difficult to attract if legal trends toward increased liability continue.¹ Others feel that the possibilities of directors incurring liability are not unduly severe.² Still other concerned authors suggest that, if a consistent body of law does not emerge in this area, directors will be discouraged from the diligent and proper performance of their duties.³ Thus it has been said that an entirely different approach to corporate management, completely redefining a director's duties and responsibilities, is necessary.⁴

Given this diverse and unsettled body of judicial precedent and scholarly commentary, how is a lawyer to advise his client who is involved in or seeking a corporate directorship?⁵ The purpose of this article is to examine

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The author gratefully acknowledges the assistance of Judith O'Neill, Executive Editor, University of Baltimore Law Review.

1. Farrell & Murphy, *Comments on the Theme: "Why Should Anyone Want to Be a Director?"*, 27 BUS. LAW. 7, 15 (spec. issue, Feb. 1972):

[B]usinessmen of the caliber we would want . . . feel or they . . . seem to feel the same, that the harassment, the public scrutiny, the threat of litigation, and the responsibilities that go with the job [of being a director], simply aren't worth the offsetting benefits.

2. Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L. J. 1078 (1968).

3. Conrad, *A Behavioral Analysis of Directors' Liability for Negligence*, 1972 DUKE L. J. 895 (No. 5).

4. See generally Vagts, *The European System*, 27 BUS. LAW. 165 (spec. issue, Feb. 1972); Vagts, *Reforming the "Modern" Corporation: Perspectives from the German*, 80 HARV. L. REV. 23 (1966).

5. Judge Gerhard Gesell addressed this problem in *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses and Missionaries*, Civil No. 267-73 (D. D. C., filed Jul. 30, 1974). While the court refused to hold directors of a non-profit hospital corporation to

the duties and potential liability of directors with an eye toward advising a client how to avoid or mitigate his exposure to personal liability.

The duty of a director in any situation depends upon the totality of the circumstances.⁶ While the facts and issues of a particular case will control the court's evaluation of its merits, a director should be aware of certain factors which have elicited a consistent reaction by the courts. If the issue is negligence in the supervision of employees, the size of the corporation is an essential element.⁷ If diversion of corporate opportunity is charged, the time lag between the corporation's initial rejection of the opportunity and the acceptance by the director is key.⁸ If a breach of the standard of care is alleged, the fact that the director is also an attorney is significant.⁹ Finally, an element which is becoming increasingly important is the status of the director as "inside" or "outside" in all situations where knowledge is an essential element for liability.¹⁰

An inside director is one who also functions as an officer of the corporation. Because of his dual capacity he has two avenues of communication and interaction with the corporation. As an officer he is involved in the day-to-day operations and decisions of the corporation. As a director, he is additionally involved in broad policy considerations of the company. His increased opportunity to be aware of the details of the corporation's activities imposes upon him a higher standard of care than that expected of the outside director.¹¹ As a practical matter, the latter often has no contact with the corporation except for annual or semi-annual board meetings. His input and influence is generally limited by his lack of involvement. While apathy or lack of presence will not excuse him from his duties as a director, his outside status will probably weigh against liability when all the circumstances are evaluated.¹²

Besides the factual elements which may underly a director's liability, the legal conceptualization of his position is an equally important concern. While a director is traditionally thought of as a fiduciary,¹³ such an

a higher standard of care than other directors, it found liability for breach of their fiduciary duty of care in the exercise of corporate management. The remedy allowed by the court was unique. Judge Gesell ordered that all directors of the corporation for the next five years read the opinion in this case to understand and appreciate the performance expected of them.

6. *Graham v. Allis-Chalmers Mfg. Co.*, 41 Del. Ch. 78, 188 A.2d 125 (Sup. Ct. 1963).

7. *Id.*

8. *Faraclas v. City Vending Co.*, 232 Md. 457, 194 A.2d 298 (1963).

9. *Cf. Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D. N.Y. 1968).

10. For a discussion of the increased significance courts are giving to the status of directors as "inside" or "outside," see 27 BUS. LAW. 123, 32-46 (spec. issue, Feb. 1972).

11. *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D. N.Y. 1968); see also the early Illinois case of *Walleck v. Billings*, 277 Ill. 218, 115 N.E. 382 (1917), where a similar distinction was made between resident and non-resident directors. This case demonstrates that increased access to information which precipitates increased liability of directors is not a new principle. Rather it is a logical conclusion when viewed as one more factor in the totality of the circumstances.

12. What the SEC Experts of Corporate Directors, SEC Press Release, Wash., D.C. (Dec. 17, 1974).

13. *Lawson v. Baltimore Paint & Chem. Corp.*, 347 F. Supp. 967, 977, (D. Md. 1972); *Parish v. Milk Producers Ass'n*, 261 Md. 618, 679-80, 277 A.2d 19, 47-48 (1971); 3 W. FLETCHER,

approach to analyzing liability may be misleading. It is true that, as a manager of the corporation, a director is responsible for the proper utilization of investment funds with which the shareholders have entrusted him. This responsibility has led to the notion that a director stands somewhat in the position of a trustee.¹⁴ Nevertheless, there are numerous instances in which the director's conduct is not judged by the traditional concepts of fiduciary duty, but rather by principles of agency or approaches independent of either fiduciary duty or agency.¹⁵

Therefore, rather than analyze the liability of a director solely within the law of fiduciaries, the analysis will be approached through three major areas of responsibility. These areas of analysis, which will assist the director in predicting the consequences of his behavior, will be discussed in the following order:

I. *The duty of loyalty*—This is the most all-encompassing of a director's responsibilities. It requires that a director never realize personal gain at the expense of stockholders of the corporation, or because of his position as a director.¹⁶

II. *The duty to exercise proper business judgment and avoid gross negligence*—¹⁷ In Maryland the standard of care imposed upon the director is that he not conduct the business of the corporation in a grossly negligent manner.¹⁸

III. *Statutory responsibility*—Besides the obvious need to comply with the terms of the local corporate code, a director must be careful not to violate federal and state securities laws.

I. THE DUTY OF LOYALTY

This duty affects all actions of a director in his official capacity which relate, in any way, to his personal interests.¹⁹ The scope of liability is very broad in this category, but most actions commonly fall into one of four areas: conflicting and competing interests, purchase and sale of control, declaration of dividends, and the usurpation of corporate opportunity.

CYC. CORP. § 838 (perm. ed. 1965): "Directors and other officers, while not trustees in the technical sense in which that term is used, occupy a fiduciary relation to the corporation and to the stockholders as a body."

14. *Id.*; see also H. BALLENTINE, CORPORATE LAW § 66 at 167 (rev. ed. 1946) (Where the corporation is in receivership, the position of director may be accurately described as that of a trustee).

15. Traditionally, a fiduciary is not excused from liability for error because he has relied on counsel's advice. See, e.g., *Brown v. Fidelity Union Trust Co.*, 135 N.J. Eq. 404, 414, 39 A.2d 120, 127 (1944). A director, however, who has acted upon the advice of counsel has generally been absolved of liability. See, e.g., *Gilbert v. Burnside*, 13 App. Div. 2d 982, 983, 216 N.Y.S.2d 430, 432 (1961).

16. *Indurated Concrete Corp. v. Abbott*, 195 Md. 496, 74 A.2d 17 (1950).

17. *Graham v. Allis-Chalmers Mfg. Co.*, 41 Del. Ch. 78, 188 A.2d 125 (Sup. Ct. 1963).

18. *Parish v. Maryland & Va. Milk Producers' Ass'n, Inc.*, 250 Md. 24, 242 A.2d 512 (1968).

19. *Litwin (Rosemarin) v. Allen*, 25 N.Y.S.2d 667, 667-68 (Sup. Ct. 1940).

A. Conflicting and Competing Interests

Problems concerning a director's duty of loyalty most often arise because of potential or actual conflicts between his personal interests and the interests of the corporation. The most obvious conflict arises when a director enters into a contract with his corporation. The prevailing rule in the nineteenth century was that any contract between a corporation and a director was voidable at the election of the corporation or its stockholders.²⁰ In 1880, the Supreme Court considered the possibility of conflict when certain directors of a railroad company caused it to enter into a contract permitting another company to exploit the coal reserves which lay within the railroad's right-of-way.²¹ Control of the second company soon passed to these directors. Speaking for the Court, Mr. Justice Field stated:

It is among the rudiments of the law that the same person cannot act for himself and at the same time, with respect to the same matter, as the agent of another whose interests are conflicting. Thus a person cannot be a purchaser of property and at the same time the agent of the vendor. The two positions impose different obligations, and their union would at once raise a conflict between interest and duty; and, "constituted as humanity is, in the majority of cases duty would be overborne in the struggle."²²

Initially Maryland did not follow the majority rule, but adhered to an even more stringent position. The first *Cumberland Coal* case²³ held that any act of a director in which he had a personal involvement was ipso facto void.²⁴ Due to the inflexible nature of this position, the rule was relaxed shortly thereafter in the second *Cumberland Coal* case.²⁵ Maryland adopted the majority rule that transactions by interested directors are voidable and the burden of proving fairness is affirmatively on the director.

The present state to which the majority rule has evolved is that if proper disclosure has been made, a contract will be approved if it passes the independent scrutiny of the courts.²⁶ While the director still has the burden of convincing the court of his good faith and fairness,²⁷ the court will enforce

20. *Wardell v. Railroad Co.*, 103 U.S. 651 (1880).

21. *Id.*

22. *Id.* at 657-58.

23. *Hoffman Steam Coal Co. v. Cumberland Coal & Iron Co.*, 16 Md. 456 (1860).

24. *Id.* at 507-08.

25. *Cumberland Coal & Iron Co. v. Sherman*, 20 Md. 117 (1863). It is interesting to note that the court in this case equated the shareholder to a cestui que trust. As discussed above, modern law does not hold a director to the strict fiduciary standard of a trustee. *Blake v. National Research Ass'n., Inc.*, 466 F.2d 570 (4th Cir. 1972).

26. *Chesapeake Constr. Corp. v. Rodman*, 256 Md. 531, 261 A.2d 156 (1970).

27. *See, e.g., Pepper v. Litton*, 308 U.S. 295 (1939); *Mardel Sec., Inc. v. Alexandria Gazette Corp.*, 320 F.2d 890 (4th Cir. 1963); *Wilshire Oil Co. of Texas v. Riffe*, 381 F.2d 646 (10th Cir. 1967), *cert. denied*, 389 U.S. 822 (1967); *Chesapeake Constr. Corp. v. Rodman*, 256 Md. 531, 261 A.2d 156 (1970); *Cummings v. United Artist Theatre Circuit, Inc.*, 237 Md. 1, 204 A.2d 795 (1964); *David J. Greene & Co. v. Dunhill Int'l, Inc.*, —Del. Ch.— 249 A.2d 427 (Ch. 1968).

the contract if the totality of the circumstances show that it was "fair, above board and entered into in good faith."²⁸ The precise language of the test varies from jurisdiction to jurisdiction, but the result is the same. The Maryland Court of Appeals has said that such a transaction "will always be scrutinized and, if shown to be unfair and entered into in bad faith by the corporate officer, nullified. . . ."²⁹

Finally, it is necessary to examine the corporation's by-laws and charter, and the applicable statutes with regard to indemnification provisions.³⁰ Clauses in the charter and by-laws are often drafted in extremely broad language and purport to absolve the involved director of any liability, if disclosure is made, short of fraud.³¹ The validity of such clauses has generally been upheld³² and may be effective to shift the burden of proving fairness from the director to the person attacking the transaction.³³ Such a clause, however, will not preclude a court's careful examination of the fairness of the contract and, the clause should not be relied upon as a device which will materially change the common law rule.³⁴

Another relatively recent development is the enactment of state statutes generally permitting transactions between a director and his corporation if certain standards are met. Delaware, for example, provides that such a transaction shall not be void or voidable because of the relationship or because the interested director participated in the meeting of the board which approved the transaction. The director's action must satisfy the following criteria: there must be proper disclosure; it must be approved by a majority of the disinterested directors or by the stockholders; it must be fair to the corporation at the time it is approved or ratified.³⁵ Similar statutes are contained in the corporation codes of California,³⁶ New York³⁷ and a number of other states.³⁸

28. 3 W. FLETCHER, CYC. CORP. § 919 (perm. ed. 1965); see also *Chesapeake Constr. Corp. v. Rodman*, 256 Md. 531, 261 A.2d 156 (1970).

29. *Chesapeake Constr. Corp. v. Rodman*, 256 Md. 531, 536, 261 A.2d 156, 158 (1970). The Connecticut Supreme Court has stated that such dealings are subjected to rigorous scrutiny and must be shown to be in good faith and contain inherent fairness to the corporation. "The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain." *Osborne v. Locke Steel Chain Co.*, 153 Conn. 527, 534, 218 A.2d 526, 531 (1966).

30. It is increasingly common for corporate by-laws to contain indemnification clauses to reimburse directors for negligence claims against them.

31. A provision which purported to relieve the director of liability for fraud would probably be void and unenforceable as being against public policy. See MD. ANN. CODE art. 23, § 64 (1973), which limits indemnification to those instances in which the director acts in good faith.

32. *Piccard v. Sperry Corp.*, 48 F. Supp. 465 (S.D.N.Y. 1943), *aff'd per curiam*, 152 F.2d 462 (2d Cir. 1946), *cert. denied*, 328 U.S. 845 (1946); *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 293, 93 A.2d 107 (Sup. Ct. 1952).

33. *Spiegel v. Beacon Participations, Inc.*, 297 Mass. 398, 417, 8 N.E.2d 895, 907 (1937).

34. *Abeles v. Adams Eng'r Co.*, 35 N.J. 411, 173 A.2d 246 (1961).

35. DEL. ANN. CODE title 8, § 144 (a).

36. CAL. CORP. CODE § 820 (West 1955).

37. N.Y. BUS. CORP. LAW § 713 (McKinney 1963).

38. Marsh, *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 46-48 (1966).

B. Purchase and Sale of Control

Directors breach their fiduciary duty when they make use of the issuance, sale or purchase of stock by the corporation for the purpose of maintaining or obtaining voting control.³⁹ If manipulation of control is the primary motivation behind the board's stock transaction, the court will not uphold it.⁴⁰ Directors do not breach their fiduciary duty when they engage in a corporate stock purchase or sale which has a valid corporate purpose, even if the incidental effect is the perpetuation of their own control.⁴¹ Thus, while there is no easy answer to the questions involved in control by incumbents, the validity of the board's action is generally determined by the intent of the transaction and not by its ultimate effect.

The determination of intent is a product of the circumstances. A factor which weighs heavily against liability is the proven necessity to protect the corporation from being overrun by an outsider who is not likely to advance the interests of the corporation. That is, the case may revolve around the characterization of the person seeking control as a "raider" rather than an analysis of a director's duty. Several leading Delaware cases demonstrate the point.

In *Cheff v. Mathes*⁴² the court upheld the directors' purchase of corporate stock with corporate funds. It reasoned that since the outsider seeking control was not highly regarded by certain bankers and had been instrumental in the liquidation of a number of companies, the directors were justified in their effort to thwart the outside bid for take-over. This was consistent with the court's previous statement that the purchase of a corporation's own stock is a valid method of eliminating what the directors deem to be a threat to the business.⁴³

In *Kors v. Carey*, U Company had 16% of L Company's stock and was attempting to gain control. L Company's directors learned of certain business policies of U Company which they felt were adverse to the corporate interest. To protect the corporation, L Company's directors used corporate funds to repurchase U Company's interest.⁴⁴ U Company contended that L Company's directors executed the repurchase solely to perpetuate their own control. In upholding the directors' action the court stated that purchase of the corporation's own stock is a valid method of eliminating what the board of directors ascertain to be a threat to the business. The court rejected the contention that the directors manipulated the corporate stock for the purpose of retaining control.

On the other hand, the court found no business justification under similar facts in *Condec v. Lunkenheimer Co.*⁴⁵ C Company bought slightly more

39. *Yasik v. Wachel*, 25 Del. Ch. 247, 17 A.2d 309 (Ch. 1941).

40. *Cummings v. United Artists Theatre Circuit, Inc.*, 237 Md. 1, 20, 204 A.2d 795, 805 (1964).

41. *Mortgage Bond Ass'n v. Baker*, 157 Md. 309, 145 A. 876 (1929).

42. 41 Del. Ch. 494, 199 A.2d 548 (Sup. Ct. 1964).

43. *Kors v. Carey*, 39 Del. Ch. 47, 158 A.2d 136 (Ch. 1960).

44. *Kors v. Carey*, 158 A.2d at 140. The directors contended that United Whelan Corp. policies might have violated the Robinson-Patman Act.

45. 43 Del. Ch. 353, 230 A.2d 769 (Ch. 1967).

than one-half of the outstanding shares of L Company. Shortly thereafter, the directors of L Company voted to issue 75,000 of authorized but unissued shares of L Company's stock which lowered C Company's control of L company to below fifty per cent. Plaintiff C Company alleged that this stock issuance served no legitimate corporate purpose and was done by L Company directors to further personal interests. L Company's president responded that the board disapproved of C Company's control because C Company had excessive debt, too much dependency on governmental business, a low profit record and a bad business reputation. The court rejected this defense, finding that C Company's control did not represent a sufficient threat to the continued existence of L Company.

While the cases seem to reach opposite conclusions under similar circumstances, there are several important factual distinctions. Probably the most important of these is that in *Kors* the interest involved was only 16% while in *Condec* an existing interest of more than 50% was reduced to less than majority. When only a minority interest is involved and the director's jobs are not being immediately threatened, the court is more likely to accept the directors' business explanation for their actions.⁴⁶ Also in *Condec* the directors took affirmative action to flood out C Company's existing control, while in *Kors* the directors effected a simple repurchase to prevent the possibility of future control.⁴⁷

C. Declaration of Dividends

Within the restrictions contained in the charter, the declaration of dividends is in the sound discretion of the directors.⁴⁸ A conflict of interest may arise in dividend policy where it is in the interest of the directors not to declare proper dividends. This situation exists in a closely-held corporation which has outside non-director shareholders. The inside directors, though they also may be substantial stockholders, may be reluctant to declare dividends as they may be receiving large salaries from the corporation. They have no desire to receive dividends, particularly when such funds will not be deductible by the corporation and will be taxed to them.

Nevertheless, because of the discretionary power of dividend declaration, it is difficult for minority stockholders to maintain a successful action against the directors in order to compel them to declare dividends. The courts are reluctant to substitute their business judgment for that of the directors. Appearing to overlook the inherent conflict of interest, the courts have stated that:

In order to succeed in such an action minority stockholders assume the burden of demonstrating that the directors have acted

46. *Cf.*, *Lawson v. Baltimore Paint & Chemical Co.*, 347 F. Supp. 967 (D. Md. 1972); *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 293, 93 A.2d 107 (Sup. Ct. 1952).

47. *See, e.g.*, *Kors v. Carey*, 39 Del. Ch. 47, 158 A.2d 136 (Ch. 1960); *Martin v. American Potash & Chemical Corp.*, 33 Del. Ch. 234, 92 A.2d 295 (Sup. Ct. 1952).

48. *Schmitt v. Eagle Roller Mill Co.*, 199 Minn. 382, 388, 272 N.W. 277, 280 (1937); MD. ANN. CODE art. 23, § 37 (1967).

in bad faith, fraudulently or dishonestly in establishing the dividend policy of the corporations.⁴⁹

Although the directors of a corporation occupy a fiduciary relationship toward the stockholders...the declaration of a dividend rests in their sound discretion and one will not be compelled unless they act fraudulently, oppressively, unreasonably, or unjustly.⁵⁰

The same conflict generally does not exist in the large corporation since the failure to pay dividends will normally result in a lower market price for its stock and the increased danger of a proxy fight or tender offer. In addition, the officers generally do not own sufficient stock to be concerned with the double taxation applicable to dividends.

The language of the courts indicates that the conflict of interest inherent in dividend declaration is not subject to the same fairness test as applied to other transactions between the corporation and the director.⁵¹

D. *Diversion of Corporate Opportunity*

Directors are not, by reason of their fiduciary duty, precluded from entering into a business enterprise similar to that of the corporation they serve.⁵² However, when a business opportunity exists which will fulfill a corporate purpose, a director's fiduciary duty demands that it be taken advantage of for the corporation and not for his individual benefit.⁵³ The difficulty, in this otherwise straightforward area, is determining what is a corporate opportunity. As in most areas of fiduciary duty of directors, the totality of the circumstances approach is generally employed.⁵⁴

A corporate opportunity is anything that can be construed to be a corporate purpose or integral thereto.⁵⁵ For example, while a director may purchase the corporation's stock in his personal capacity, if the corporation had declared the repurchase of its own stock as a valid corporate purpose, the purchase by the director would breach his duty.⁵⁶ Without a corporate

49. *Cashman v. Petrie*, 14 N.Y.2d 426, 428, 201 N.E.2d 24, 25 (1964).

50. *Schmitt v. Eagle Roller Mill Co.*, 199 Minn. 382, 388, 272 N.W. 277, 280 (1937).

51. See Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259 (1967); Note, 56 NW. U. L. REV. 503 (1961); Note, 10 RUTGERS L. REV. 723 (1956).

52. *Poole v. Miller*, 211 Md. 448, 459, 128 A.2d 607, 613 (1956). The court ruled that since the leasehold interests held by the director were not desired by the lessee corporation, the latter lost nothing. The court seemed to equate loss with corporate purpose. Rather than a discussion in terms of loss or gain to the corporation, a more accurate statement of the result would be that the leasehold interest was not a corporate purpose. Therefore, no opportunity was diverted.

53. *Faraclas v. City Vending Co.*, 232 Md. 457, 194 A.2d 298 (1963).

54. *Paulman v. Kritzer*, 74 Ill. App. 2d 284, 294-95, 219 N.E.2d 541, 546 (1966). See also Fuller, *Restrictions Imposed by the Directorship Status on the Personal Business Activities of Directors*, 26 WASH. U. L. Q. 189 (1941); *The Corporate Opportunity Doctrine*, 18 SW. L. J. 96 (1964); Walker, *Legal Handles Used to Open or Close the Corporate Door*, 56 NW. U. L. REV. 608 (1961).

55. *Burg v. Horn*, 380 F.2d 897 (2d Cir. 1967).

56. *Faraclas v. City Vending Co.*, 232 Md. 457, 194 A.2d 298 (1963).

declaration or a show of cause for the purchase, some states have ruled that the acquisition of its own stock is not "ordinarily an essential corporate function."⁵⁷

The corporation's ability to take advantage of the opportunity is another factor to be considered in the totality of the circumstances test. While some jurisdictions have allowed a director to seize an opportunity which the corporation was financially unable to pursue,⁵⁸ others have vigorously rejected this approach.⁵⁹ The Second Circuit argued:

If directors are permitted to justify their conduct on such a theory, there will be a temptation to refrain from exerting their strongest efforts on behalf of the corporation since, if it does not meet its obligations, an opportunity of profit will be open to them personally.⁶⁰

A leading Maryland corporate opportunity case⁶¹ supported this criticism of the more liberal jurisdictions. In that case, the corporation was insolvent when it purported to redeem its own stock. The corporation's insolvency made it illegal for it to execute the transaction.⁶² Nevertheless, because insolvency is not necessarily permanent, the court found that the corporation's attempted repurchase established its intent. The acquisition of stock by the director was in conflict with that purpose and was a diversion of corporate opportunity.⁶³

A corporate opportunity may be implied as well as expressed. A corporation which leases its premises has as its implied corporate purpose the renewal of the lease. A director who, in his personal capacity, leases the corporation's premises upon the expiration of the existing lease, usurps a corporate opportunity.⁶⁴ Generally, anything that is essential to the corporation's existence in its present operations would be an implied corporate purpose.

If the board of directors has formally rejected a proposed venture, however, in certain instances a director may take advantage of it without breaching his duty. In a Delaware case, the board of directors of a company rejected an offer to purchase a package of shares of H Company plus a large quantity of its own shares.⁶⁵ One month after the board's rejection, a

57. *Equity Corp. v. Milton*, 42 Del. Ch. 425, 213 A.2d 439, 443 (Ch. 1965), *aff'd*, 43 Del. Ch. 160, 221 A.2d 494 (Sup. Ct. 1966).

58. *See, e.g., Santarelli v. Katz*, 270 F.2d 762 (7th Cir. 1959); *Schildberg Rock Products Co. v. Brooks*, 258 Iowa 759, 140 N.W.2d 132 (1966); *Financial Inability as a Defense under the Corporate Opportunity Doctrine*, 39 Ky. L. J. 229 (1951).

59. *Irving Trust Co. v. Deutsch*, 73 F.2d 121 (2d Cir. 1934), *cert. denied*, 294 U.S. 709 (1935); *accord, Paulman v. Kritzer*, 74 Ill. App. 2d 284, 219 N.E.2d 541 (1966), *aff'd*, 38 Ill. 2d 101, 230 N.E.2d 262 (1967).

60. *Irving Trust Co. v. Deutsch*, 73 F.2d at 124.

61. *Faraclas v. City Vending Co.*, 232 Md. 457, 194 A.2d 298 (1963).

62. MD. ANN. CODE art. 23, § 32(c) (1970).

63. *Faraclas v. City Vending Co.*, 232 Md. 457, 194 A.2d 298 (1963).

64. *The Acker, Merrill & Conduit Co. v. McGraw*, 106 Md. 536, 68 A. 17 (1907).

65. *Kaplan v. Fenton*, 278 A.2d 834 (Del. Super. 1971).

director of the corporation purchased the previously-offered stock of H Company. During the vote taken by his board, when the opportunity initially arose, the interested director had favored the purchase of H Company stock but voted against the purchase of the corporation's own stock. Also before buying the H Company stock, he had asked the president of his corporation if he wanted the offer to be resubmitted to the board. The response was negative. Nearly a year later, the board sought to acquire all of H Company's stock. The purchase included the director's shares. The corporation sued him for the profit he made on the resale to his own company. The court found that he did not usurp the corporation's opportunity to acquire the stock, and thus was not bound to pass on his profit to the corporation. The court considered the corporation's rejection absolute, making the transaction non-essential to the conduct of its business in the estimation of the board of directors. It said:

'[W]hen a business opportunity comes to a corporate officer or director in his individual capacity . . . and the opportunity is one which, because of the nature of the enterprise, is not essential to his corporation, and is one in which it has no interest or expectancy, the officer or director is entitled to treat the opportunity as his own, and the corporation has no interest in it, if, of course, the officer or director has not wrongfully embarked the corporation's resources therein.'⁶⁶

If there had not been such overwhelming evidence of the director's good faith, the court might have found diversion of corporate opportunity.

When diversion of corporate opportunity is found to exist, a constructive trust may be imposed upon the profits diverted from the corporation to the interested director.⁶⁷

II. THE DUTY TO AVOID GROSS NEGLIGENCE

A director can control his integrity and is therefore required by the law to do so. On the other hand, he is human and subject to ordinary, undesirable human characteristics such as misjudgment and negligence. Because the courts recognize that these shortcomings exist, the courts do not look for infallibility of a director in the performance of his duty.⁶⁸ Instead, a director is liable only for gross negligence and culpable mismanagement.⁶⁹

Historically in Maryland "the *onus* of the proof of . . . gross negligence, to render the directors personally liable is upon the party making the

66. *Id.* at 836 *quoting*, *Guth v. Loft*, 23 Del. Ch. 255, 5 A.2d 503, 510-11 (Ch. 1939):

67. *Craig v. Graphic Arts Studio, Inc.*, 39 Del. Ch. 447, 166 A.2d 444 (Ch. 1960).

68. *Booth v. Robinson*, 55 Md. 419 (1881). The court said: "Blunders of the grossest sort are readily tolerated, if they can be attributed to anything short of fraud. It is fraud alone that will render a director personally responsible. . . ." *Id.* at 426. This is somewhat of an overstatement of the law as it has developed today. Gross and "culpable" negligence are actionable without fraud. 1 HENN, *LAW OF CORPORATIONS* § 235 (2d ed. 1970).

69. *Id.*

charge...."⁷⁰ The policy behind this result is that to hold a director personally liable for an unwise decision is to discourage all responsible people from acting as a corporate officer or director. Therefore, the Maryland court is as liberal in excusing poor judgment as it is rigid in punishing self-dealing or dishonesty.⁷¹ Only gross negligence tantamount to recklessness or fraud will be punished.⁷²

Where the board of directors approved a loan to a financially threatened company which soon went insolvent, the court found no waste of corporate assets.⁷³ It conceded that the defendant directors might have been imprudent, but the court refused to scrutinize their business judgment where the facts revealed no "gross negligence and inattention to the duties of their trust,"⁷⁴

However, when negligence is alleged and there is an element of self-dealing, the court is more likely to find liability for mismanagement, if not gross negligence. Where the corporation sustained a loss due to loans executed to the directors from corporate funds, the court found gross negligence and culpable mismanagement.⁷⁵ In the earliest of these cases, the court held the directors personally liable for the loss to the corporation caused by their loans to another director.⁷⁶ While this case was a gross negligence action, it had overtones of directors' exercising their selfish interests by "team playing." It is easier for the court to find gross negligence if some self-interest is present.

In *Murphy v. Penniman*⁷⁷ the directors discovered that a fellow officer had misappropriated \$78,000.00 of corporate funds. The directors voted to construe the misappropriation as a loan, and accepted from the debtor a written promise of payment secured by collateral valued at only \$50,000.00. The court found this action to be a business judgment. It was in the board's discretion to determine if getting at least \$50,000.00 was best for the corporation; however, the court found gross negligence on the part of the entire board where the same officer who misappropriated the funds was retained as treasurer and later promoted to vice-president. It held that the stockholders could recover from the directors if they could prove that this action caused the ultimate financial destruction of the corporation.⁷⁸

A director of a finance corporation was also liable for gross negligence

70. *Booth v. Robinson*, 55 Md. 419, 438 (1881).

71. *Cf.*, *Burkhart v. Smith*, 161 Md. 398, 157 A. 299 (1931).

72. *Id.*

73. *Id.*

74. *Id.* at 403, 157 A. at 301. This case involved an interlocking directorate which, as stated above, does not presume unfair personal interest. *See also* *Booth v. Robinson*, 55 Md. 419 (1881).

75. *Devereux v. Berger*, 264 Md. 20, 284 A.2d 605 (1971); *Hagerstown Furniture v. Baker*, 155 Md. 549, 142 A. 885 (1928); *Murphy v. Penniman*, 105 Md. 452, 66 A. 282 (1907).

76. *Murphy v. Penniman*, 105 Md. at 463. Although the by-laws prohibited such loans, it was not the determinative factor in the outcome of the case.

77. 105 Md. 452 (1907).

78. *Id.* This is distinguishable from the personal interest cases, in which no loss to the corporation need be shown. This is an important factor for the plaintiff to consider before deciding under which theory to bring his action.

when he caused the corporation to borrow money at 12 percent interest and reloan it to another company for 9 percent interest.⁷⁹ Although he was president of the second corporation, an intentional diversion of corporate funds would have been more difficult than negligence because the transactions between interlocking directorates are presumptively fair.

While these cases indicate that Maryland holds a director liable only for gross negligence, holding him to the standard of care that he would use in the conduct of his own affairs,⁸⁰ a conflict in jurisdictions exists as to the standard of care required. An early Pennsylvania case⁸¹ took a position similar to that of Maryland. The court said that only "gross inattention" tantamount to fraud is culpable while "mistakes of judgment" are not.⁸² A leading New York case rejected this conclusion saying that a director must exercise "ordinary skill and judgment."⁸³ The court analogized the director's position to that of a trustee. It stated that to hold him to "only slight care to the duties of his trust..."⁸⁴ undermines the confidence which investors must place in him. Later New York cases⁸⁵ failed to maintain this standard. Instead, the court adopted a theory similar to the Maryland and Pennsylvania decisions. It said that the best interest of the corporation is served by the exercise of the directors' "honest and unselfish decision" even though it may be viewed subsequently as "unwise or inexpedient."⁸⁶

The rule that a director is excused from liability for anything but the grossest of negligence is characterized as the "business judgment" rule.⁸⁷ The conflict between this position and the rule of ordinary care and judgment is illustrated in an early Supreme Court decision.⁸⁸ There, outside directors of a national bank were sued for dereliction of duty. The allegation was that they had utterly failed to supervise the officers of the bank with the result that the officers completely milked the bank, leaving it insolvent. The majority opinion by Mr. Chief Justice Fuller, while paying lip service to the rule of ordinary care, so evaluated the facts that the case must stand as a high-water mark of judicial permissiveness. Four Justices dissented, led by Mr. Justice Harlan. The dissenting opinion noted sarcastically:

Upon his [the director's] theory of duty [accepted by the majority opinion], the only need for directors of a national bank is to meet, take the required oath to administer its business diligently and honestly, turn over all its affairs to the control of some one or more of its officers, and never go near the bank again, unless they are

79. *Devereux v. Berger*, 264 Md. 20, 284 A.2d 605 (1971).

80. *Phoenix Sav. & Loan, Inc. v. Aetna Cas. & Serv. Co.*, 427 F.2d 862, 868 (4th Cir. 1970).

81. *Sperling's Appeal*, 71 Pa. 11 (1872).

82. *Id.* at 24.

83. *Hun v. Cary*, 82 N.Y. 65, 71 (1880).

84. *Id.* at 72.

85. *See, e.g., Pollitz v. Wabash R.R. Co.*, 207 N.Y. 113, 100 N.E. 721 (1912).

86. *Id.* at 124, 100 N.E. at 724.

87. *Murphy v. Penniman*, 105 Md. 452 (1907).

88. *Briggs v. Spaulding*, 141 U.S. 132 (1891).

notified to come there, or until they are informed that there is something wrong. And when it is ascertained that these officers or some of them, while in full control, have embezzled or recklessly squandered the assets of the bank, the only comfort that swindled stockholders and depositors have is the assurance, not that the directors have themselves diligently administered the affairs of the bank, or diligently supervised the conduct of those to whom its affairs were committed by them, but that they had confidence in the integrity and fidelity of its officers and agents, and relied upon their assurance that all was right.... Such a system cannot be properly characterized otherwise than as a farce.⁸⁹

There is a persuasive argument for the application of the "business judgment" rule at least where outside directors are concerned, though it has not been expressly recognized by the courts. Practical experience and actual interviews with directors and management of large corporations show that the functions of outside directors are limited. Professor Myles L. Mace has suggested that outside directors do no more than serve as sources of advice and counsel on very broad questions of policy, and as some sort of discipline in requiring management to prepare periodic reports to the board. Directors serve actively only in the event of a crisis, such as the death of the president or a tender or take-over offer.⁹⁰ In such circumstances, then, it would be basically unfair to impose a standard of reasonable care and diligence. Rather, all that can be expected is liability for gross negligence or inattention to duty. Moreover, the imposition of a higher standard would not necessarily result in better service by the director.⁹¹ Human nature being what it is and possessing a strong instinct for self-preservation, directors would seek, perhaps successfully, to avoid the liabilities imposed by a higher standard through the methods of liability insurance or indemnification by their corporation.⁹² If these avenues of escape were

89. *Id.* at 168-69.

90. See generally M. MACE, *DIRECTORS: MYTH AND REALITY* (1971), a three year study based upon extensive interviews and research. Professor Mace quotes, with obvious relish, from many of his interviews. For example, on whether outside directors ask discerning questions, he quotes one chairman:

A board meeting is not a good place, relatively speaking, to raise questions. The reason is a sort of atmospheric reason. The fellow board member who has interest enough or knowledge enough to challenge the management with a perceptive question is probably very much in the minority. In most cases he is the one guy on the board who has some interest and feeling, and the rest of the characters on the board haven't read the material, don't know the business, can't make any sensible response with justification, and they are not really interested in getting into it. *Id.* at 52.

91. See Conrad, *A Behavioral Analysis of Directors' Liability for Negligence*, 1972 DUKE L. J. 895 (No. 5).

92. Though liability insurance may appear to be the salvation of the corporate director, it is not the total solution to the problem. Beside the expense and difficulty of finding coverage, policies may be vague, and their terms are always subject to interpretation by the law and by the control of the corporate code. It is difficult for a director to know whether a particular negligent act is covered until after the fact. In general, intentional acts of wrongdoing cannot be insured as a matter of public policy though some jurisdictions may permit it. For a discussion of the pitfalls and advantages of liability insurance

closed, persons might refuse to serve as directors, or directors might attempt to build "paper shelters," establishing a record of diligence without any necessary correlation to actual diligence.⁹³

Nevertheless, many observers of the corporate entity believe that directors will, in many areas, eventually become liable for negligent action.⁹⁴ As reviewed below in the discussion of liability under federal law, such liability may already exist in certain areas of directors' action relating to the issuance of securities.

Finally, it is important to point out that gross negligence may be established not only if a director fails to act affirmatively in the best interests of the corporation, but also if he fails to act at all when there is a duty to do so.⁹⁵ A director may not insulate himself from corporate affairs to such an extent that his attentiveness is less than that which "a discrete businessman would exercise over his own affairs. . . ."⁹⁶

For example, where supervision of corporate employees is at issue in the determination of misfeasance (which is generally non-actionable) or non-feasance (which is generally actionable), the size of the corporation is an important factor.⁹⁷ Directors of a corporation with 30,000 employees are entitled to rely on employee honesty until put on notice of a wrongdoing,⁹⁸ while directors of a small corporation may have a duty to actively supervise their employees.⁹⁹ Of course, directors with knowledge of employee misconduct have a fiduciary duty to act, regardless of the size of the corporation.¹⁰⁰

III. LIABILITY UNDER FEDERAL SECURITIES LAWS

The influence of the federal securities laws¹⁰¹ has been so pervasive and widespread in the past several years that many practitioners are beginning to refer to them as "the federal law of corporations." The purpose of these laws is to "insure the maintenance of fair and honest markets"¹⁰² in

for corporate directors see S. Miller and J. Subak, *Lessons for Future Counselling of Insurers Involving Ethics, Liabilities, and Securities Regulation: Impact of Federal Securities Laws: of Officers, Directors, and Accountants*, 30 BUS. LAW. 387 (1975); J. Hinsey and W. DeLancey, *Directors and Officers Liability Insurance—An Approach to Its Evaluation and A Checklist*, 23 BUS. LAW. 869 (1968).

93. Conrad, *supra* n. 91 at 903-04.

94. Cary & Harris, *Standards of Conduct under Common Law, Present Day and the Model Act*, 27 BUS. LAW. 61, 70 (spec. issue, Feb. 1972).

95. Parish v. Maryland & Va. Milk Producers' Ass'n, Inc., 250 Md. 24, 76, 242 A.2d 512 (1968).

96. Fisher v. Parr, 92 Md. 245, 48 A. 621 (1901).

97. Graham v. Allis-Chalmers, 41 Del. Ch. 78, 188 A.2d 135 (1963).

98. *Id.*

99. Fisher v. Parr, 92 Md. 245, 48 A. 621 (1901).

100. Parish v. Maryland & Va. Milk Producers' Ass'n, Inc., 250 Md. 24, 242 A.2d 512 (1968).

101. The Securities Act of 1933, Securities Exchange Act of 1934 and Investment Company Act of 1940 have generated the greatest activity and interest.

102. 15 U.S.C. § 78b (1970). The other enumerated purposes of this Act are "to protect interstate commerce, the national credit, the Federal taxing power, . . . the national banking system and Federal Reserve System"

securities exchanges, in order to "protect the uninformed, ignorant, and gullible"¹⁰³ investor. The widespread use of securities as the financing foundation of our economic structure created the potential for their misuse by directors to defraud the public.¹⁰⁴ Sections 77 and 78 of the United States Code, Title 15¹⁰⁵ exemplify the congressional effort to "prevent the . . . exploitation of the public by the sale of unsound, fraudulent and worthless securities through misrepresentation"¹⁰⁶ and distortion of the market value of the enterprise involved.¹⁰⁷ To accomplish this, Congress required the full and fair disclosure of all securities sold in interstate commerce or through any instrumentality thereof.¹⁰⁸

Because of the rigid structure and remedial purpose of the federal securities laws, the benefits to a plaintiff of proceeding under them instead of state laws is enormous. The standard of care imposed by federal law upon directors is more strict and the procedural problems are less cumbersome. For example, many states have "security for expense" statutes which require that the plaintiff post sufficient security to finance his challenge.¹⁰⁹ Also there can be problems in service of process and in establishing jurisdiction and venue, particularly where there are multiple defendants. Under federal law there is: no security for expenses, worldwide service of process, liberal discovery and class action procedures, relatively liberal rules on derivative suits and jury trials, broad venue, no minimum on the amount of money in controversy, and no requirement for diversity of citizenship.¹¹⁰

Like state laws, the federal statutes impose specific duties and liabilities upon directors. Three significant portions of the federal securities laws which will be discussed herein are Section 16(b) of the Securities Exchange Act of 1934, Section 11 of the Securities Act of 1933, and Rule 10b-5.

Section 16(b) of the Securities Exchange Act imposes liability upon directors and officers for short-swing profits. The liability for such profits incurs from the use by a beneficial owner, officer or director of inside information to sell a security for profit within six months of its purchase. This section generally applies irrespective of the intent of the director and whether he acted in good or bad faith.¹¹¹ It is construed strictly so that if computation of profit can be done by more than one method, that method

103. *Surowitz v. Hilton Hotels Corp.*, 342 F.2d 596, 602 (7th Cir. 1965).

104. The Securities Exchange Act of 1934 is "essentially directed at fraud, not against mere negligence or errors of judgment on the part of the broker." *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 430 (N.D. Cal. 1968).

105. These sections encode the Securities Act of 1933 and the Securities Exchange Act of 1934, respectively.

106. *El Khadem v. Equity Sec. Corp.*, 494 F.2d 1224 n.7 (9th Cir. 1974).

107. *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973), *cert. denied*, 414 U.S. 910 (1973).

108. *Texas Continental Life Ins. Co. v. Bankers Bond Co.*, 187 F. Supp. 14 (W.D. Ky. 1960).

109. See, e.g., CAL. CORP. CODE § 34 (West 1955); N.Y. BUS. CORP. LAW § 627 (McKinney 1963); TEX. BUS. CORP. ACT art 5.14.C (Vernon Supp. 1974).

110. A. BROMBERG, *SECURITIES LAW: FRAUD, SEC. RULE 10b-5*, 0.84.4-.5 (1967).

111. *Marquette Cement Mfg. Co. v. Andreas*, 239 F. Supp. (S.D. N.Y. 1965); *Lockheed Aircraft Corp. v. Campbell*, 110 F. Supp. 282 (S.D. Cal. 1953).

yielding the highest profit for the plaintiff is used.¹¹² A suit for recovery of such profits may be brought within two years by any person who owns securities of the issuer or by the issuer itself. Because the information used by the director was obtained through his position as an insider, a 16(b) action is somewhat analogous to a common law suit for breach of fiduciary duty through insider trading.

Section 11 of the Securities Act of 1933 imposes liability upon directors and officers if securities are issued pursuant to a registration statement which contains untrue statements or omits to make statements of material fact. In the famous case of *Escott v. BarChris Construction Co.*¹¹³ the district court examined in detail the duties of both inside and outside directors concerning the preparation of a registration statement and the resulting issuance of stock. Under Section 11(a) (2) an injured purchaser may sue all directors of the corporation that issued the misleading registration statement. If the statement was "purporting to be a copy of . . . a report or valuation of an expert . . ." ¹¹⁴ subsection (b)(3) allows the vulnerable directors to avoid liability by proving that "[they] had, after a reasonable investigation, reasonable ground to believe and did believe . . . that the statements therein were true and that there was no omission to state a material fact . . ." ¹¹⁵ The court specifically considered whether the directors had sustained their burden of proof under Section 11(b)(3). The court found that they did not.

Thus liability for negligence is significantly different under the federal securities law from common law theories of director liability in at least two respects. First, an affirmative duty is imposed upon the director, even in the absence of self-dealing, to institute a reasonable investigation. This contrasts with the freedom afforded by the "business judgment" rule asserted by the common law.¹¹⁶ Secondly, the burden is placed upon the director to prove his compliance with the exculpatory portions of the statute.

While *BarChris* arose in the context of a corporate stock issuance, its lessons are equally applicable to all statements and reports filed pursuant to the Securities Exchange Act of 1934. Other documents subject to the section are the periodic reports which a reporting company must file under Section 13 and the proxy materials filed under Section 14. While the outside director may not have the same degree of statutory responsibility for those reports as he does under the Securities Act, he probably will be held liable if he fails to make a reasonable inquiry or investigation of such reports.¹¹⁷

112. *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir. 1943), *cert. denied*, 320 U.S. 751 (1943); *Newmark v. RKO Gen., Inc.*, 425 F.2d 348 (2d Cir. 1970), *cert. denied*, 400 U.S. 854 (1970).

113. 283 F. Supp. 643 (S.D. N.Y. 1968).

114. 15 U.S.C. § 77k (1970).

115. *Id.*

116. Indeed, the underwriter defendants in *BarChris* attempted to rely upon *Litwin v. Allen*, 25 N.Y.S.2d 667 (Sup. Ct. 1940), saying that they were entitled to assume that the officers of the company were honest. Judge McLean refused to accept this analogy. *Escott v. BarChris Constr. Co.*, 283 F. Supp. 643, 696 (S.D. N.Y. 1968).

117. Meeker, *The Outside Director — Advice to My Client*, 24 Bus. Law. 573, 580 (1969).

A significant sequel to *BarChris* is *Feit v. Leasco Data Processing Equipment Corp.*¹¹⁸ Both inside and outside directors were sued under Section 11 of the Securities Act of 1933, for alleged material misrepresentations contained in a prospectus issued by Leasco, in making a tender offer for the stock of Reliance Insurance Company. The inside director was held liable; however, the court exonerated the outside director, who was also an officer of the managing underwriter. This decision makes clear the rigors of the inside director's burden of affirmatively investigating all of the company's activities.

Since *Feit*, moreover, the inside director's burden is nearly impossible to meet. There was no question of the honesty of the Leasco directors, but Judge Weinstein noted, in analyzing their duty:

BarChris imposes such stringent requirements of knowledge of corporate affairs on inside directors that one is led to the conclusion that liability will lie in practically all cases of misrepresentation. Their liability approaches that of the issuer as guarantor of the accuracy of the prospectus.¹¹⁹

A similarly critical area of directors' duties arises under Rule 10b-5.¹²⁰ This rule regulates purchases and sales of securities and creates substantial concerns for the director, both when he has a personal interest in the securities transaction and when he does not. The scope of the Rule has constantly expanded since it was first held in 1947 that a private right of action was created by a violation of Rule 10b-5.¹²¹ It is impossible to analyze completely the Rule in this article¹²² but certain features of the Rule are important to a proper analysis of a director's liability.

One significant feature is that a director or officer may not trade for his own account in the stock of his company using undisclosed and material, inside information. This is the lesson of the leading case of *SEC v. Texas Gulf Sulfur Co.*¹²³

118. 332 F. Supp. 544 (E.D. N.Y. 1971).

119. *Id.* at 578. See also, Folk, *Civil Liabilities under the Federal Securities Acts: The BarChris Case* (pt. 1), 55 Va. L. Rev. 1 (1969).

120. 17 C.F.R. § 240.10b-5 (1942):

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

121. *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947), *modified*, 83 F. Supp. 613 (1947).

122. For an exhaustive treatment of Rule 10b-5 see A. BROMBERG, *SECURITIES LAW: FRAUD, SEC. RULE 10b-5* (1967); J. FLOM, B. GARFINKEL & J. FREUND, *DISCLOSURE REQUIREMENTS OF PUBLIC COMPANIES AND INSIDERS* (1967).

123. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), 404 U.S. 1005 (1971), *reh. denied*, 404 U.S. 1064 (1972). The court held that a director of the company could not

Many practitioners have approached the *Texas Gulf* decision as presenting an ultimatum to the director of either disclosing or violating the Rule. Since, as explained below, even a conscientious director can never be sure he has made full disclosure, the threat of liability is always present under that analysis. An obvious alternative is for the insider not to trade for his own account. This third alternative is the safest for a director or other insider and avoids the difficult task of balancing legitimate corporate concerns for nondisclosure against the public policy arguments that trading must be based upon full and truthful disclosure of material information.¹²⁴

The director should adopt a very broad view of materiality. The mere fact that he purchased shares may be used as evidence that he considered the undisclosed information to be material.¹²⁵ At the very least, he must recognize that the test of materiality will be judged on the basis of hindsight, and that materiality may encompass "any fact . . . which in reasonable and objective contemplation might affect the value of the corporation's stock or securities . . ." ¹²⁶ The director will not escape liability if, rather than trading for himself in his corporation's securities, he passes the inside information to a friend or relative who then trades. The director will be branded a "tipper" and will be subject, at the very least, to injunctive action¹²⁷ and possibly to civil suits seeking to hold him liable for the profits made by his "tippee."¹²⁸

A second important application of Rule 10b-5 is that directors and officers may be charged for breach of fiduciary duty in cases involving a securities transaction and a conflict of interest. The leading case is *Schoenbaum v. Firstbrook*,¹²⁹ where a stockholder's derivative suit was brought against certain directors of Banff Oil Ltd. alleging that the directors, having knowledge of certain oil discoveries, issued stock of Banff to its controlling stockholder at a grossly inadequate price. The district court had entered summary judgment for all defendants, but was reversed on appeal. The court of appeals ruled that the complaint stated a cause of action in that the directors of Banff may have defrauded their corporation

trade in the stock of the company while material information had not been disclosed—that the directors had acted to reduce the dividend. The SEC disciplined a broker who had obtained this inside information from the director and sold shares of the company's stock before news of the reduction had been made public.

124. While this third course will insulate the director from liability, the corporation itself may have to wrestle with only the two choices—to disclose or to violate the Rule. Still unclear is whether the corporation will be held liable to private investors in the absence of some form of scienter. *SEC v. Texas Gulf Sulfur Co.*, 401 F.2d at 866-68 (dissenting opinion).
125. *Id.*; *Faberge, Inc.*, SEC Securities Exchange Act Release No. 10174 (May 25, 1973); see also, *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).
126. *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir. 1965), cert. denied, 382 U.S. 811 (1965), reh. denied, 382 U.S. 933 (1965); citing, *Kohler v. Kohler Co.*, 319 F.2d 634, 642 (7th Cir. 1963); accord, *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968).
127. *SEC v. Texas Gulf Sulfur Co.*, 401 F.2d at 852.
128. DeLancey, *Rule 10b-5—A Recent Profile*, 25 BUS. LAW. 1355, 1361-62 (1970); cf., *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 315 F. Supp. 42 (D.Col. 1970).
129. 405 F.2d 200 (2d Cir. 1968), rev'd en banc, 405 F.2d 215, cert. denied, 395 U.S. 906 (1969).

by causing Banff to receive less for the sale of its shares than it should have.¹³⁰

The importance of *Schoenbaum* lies in the fact that it overruled the earlier proposition, derived from *Birnbaum v. Newport Steel Corp.*,¹³¹ that corporate mismanagement, even if fraudulent, could not be litigated under Rule 10b-5. It still may be possible to argue that Rule 10b-5 will not reach corporate mismanagement if the alleged securities transaction is merely incidental to the mismanagement.¹³²

A further expansion of Rule 10b-5 will be realized if the "purchaser-seller" requirement of *Birnbaum v. Newport Steel Corp.* is rejected. *Birnbaum* established that, in order for a plaintiff to have standing, he must be either a purchaser or seller of securities. This status was considered essential because of the concluding phrase of Rule 10b-5, "in connection with the purchase or sale of any security." Although *Birnbaum* had been criticized over the years,¹³³ and although several exceptions had been established,¹³⁴ its holding was not challenged directly until the decision of the Seventh Circuit Court of Appeals in *Eason v. General Motors Acceptance Corp.*¹³⁵ The Seventh Circuit affirmatively answered the question "whether notwithstanding the fact that they are neither purchasers nor sellers of security, plaintiffs may obtain relief under Rule 10b-5."¹³⁶

While there must still be a purchase or sale of a security,¹³⁷ if the other circuits or the Supreme Court¹³⁸ adopt the holding that the plaintiff need

130. *Id.* at 219. Judge Medina said in his dissent:

This does indeed open the flood gates. For the result is to transform a simple cause of action against directors for waste or the use of bad judgment in the sale of corporate assets into a federal securities fraud case by judicial fiat. In my opinion the Congress never intended the Securities Exchange Act of 1934 to be interpreted so broadly as this. *Id.* at 220.

131. 193 F.2d 461 (2d Cir. 1952), *cert. denied*, 343 U.S. 956 (1952); *followed in* O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964); *Lester v. Preco Indus., Inc.*, 282 F. Supp. 459 (S.D. N.Y. 1965).

132. *Tully v. Mott Supermarkets, Inc.*, 337 F. Supp. 834, 842 (D. N.J. 1972):

It would be inaccurate to conclude that Rule 10b-5 jurisdiction exists in a case of nothing more than corporate mismanagement where the purchase or sale of stock has a purely speculative impact on the cause of action. But, where there is a causal connection between the purchase or sale of stock, the alleged fraud or breach of fiduciary duty, and plaintiff's loss, then federal jurisdiction under 10b-5 exists.

133. *See, e.g.*, Lowenfels, *The Demise of The Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968); Ruder, *Current Developments in the Federal Law of Corporate Fiduciary Relations — Standing to Sue under Rule 10b-5*, 26 BUS. LAW. 1289 (1971).

134. *See* Ruder, *id.* at 1296-1300, listing the derivative action exception, the forced seller exception, mergers and liquidations, proxy rule cases and the injunction exception; *see also*, A. S. Jacobs, *Birnbaum in Flux: Significant 10b-5 Developments*, 2 SEC. L. J. 305 (1975).

135. 490 F.2d 654 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

136. *Id.* at 656.

137. *In re Penn Cent. Sec. Litigation*, 494 F.2d 528, 533 (3d Cir. 1974).

138. The Supreme Court's opinion in *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971), may be read as implying a disposition to do away with the purchaser-seller requirement. *id.* at 12. However, the Court has also shown a reluctance to become embroiled in the dispute, since it denied certiorari in *Eason*, despite the obvious conflict among the circuits.

not be a purchaser or seller, it will enormously enlarge the application of Rule 10b-5 and greatly increase the number of situations to which it will apply. Thus nonselling stockholders who see their shares diminish in value as the result of a fraudulent tender offer or merger; or who have their shares diluted by the improper issuance of stock to insiders; or who find the value of their shares decreasing as a result of mismanagement, fraud or manipulation by insiders, all may find standing to sue under Rule 10b-5. Naturally the corresponding duties and liabilities of the officers and directors will be increased substantially.

This possible expansion of the Rule's application brings into sharp focus the current issue of the duty of care which must be exercised to avoid liability in Rule 10b-5 cases. The question is whether the standard is flexible and dependent upon the circumstances or controlled by an affirmative act such as fraud or scienter. The Second Circuit in *Lanza v. Drexel & Co.*¹³⁹ concluded that the liability for misrepresentation of a director who has no conflict of interest would not attach without the presence of the element of willfulness or recklessness.¹⁴⁰ *Lanza* was a suit by the stockholders of a small company who had entered into a stock exchange with BarChris Construction Company. The plaintiffs could not claim the protection of Section 11 of the Securities Act as the exchange was admittedly not a public issue and was, therefore, exempt from the registration requirements and concomitant liabilities under the 1933 Act. Thus they brought suit against the former officers and directors under Rule 10b-5. The court was concerned primarily with the duty owed by an outside director and refused to apply a negligence standard, saying, "In sum, we believe that proof of a willful or reckless disregard for the truth is necessary to establish liability under Rule 10b-5."¹⁴¹

The Ninth Circuit came to a different conclusion. That court, in *White v. Abrams*,¹⁴² expressly refused to follow *Lanza*. It rejected the attempt to compartmentalize the defendant's state of mind, whether using the term "scienter" or the term "negligence." Rather, it insisted that a "flexible standard" was necessary in order "to meet the varied factual contexts without inhibiting the standard with traditional fault concepts which tend to cloud rather than clarify."¹⁴³ The court listed a number of factors which

139. 479 F.2d 1277 (2d Cir. 1973).

140. *Id.* at 1299.

141. *Id.* In a footnote, the Court said:

In determining was [sic] constitutes "willful or reckless disregard for the truth" the inquiry normally will be to determine whether the defendants knew the material facts misstated or omitted, or failed or refused, after being put on notice of a possible material failure of disclosure, to apprise themselves of the facts where they could have done so without any extraordinary effort.... The answer to the inquiry will of course depend upon the circumstances of the particular case, including the nature and duties of the corporate positions held by the defendants. *Id.* at 1306.

142. 495 F.2d 724 (9th Cir. 1974). *White* was not a suit against either directors or officers, but the court's analysis makes it clear that the same approach would have been followed had the defendants been directors or officers.

143. *Id.* at 734.

should be considered in defining, on a case by case basis, the duty imposed by Rule 10b-5 upon the defendant:

- a) the relationship of the defendant to the plaintiff;
- b) defendant's access to information as compared to plaintiff's;
- c) the benefit defendant derives from the relationship or transaction;¹⁴⁴
- d) defendant's awareness of whether plaintiff was relying upon their relationship in making his investment decisions; and
- e) defendant's activity in initiating the securities transaction in question.¹⁴⁵

What lies in the future for directors under Rule 10b-5? The answer seems to be increasing litigation and liability. With a movement toward an increased scope of the Rule as exemplified in *Eason* and a flexible duty of care as espoused in *White v. Abrams*, the director will be less certain of his liabilities and more apprehensive about serving as a director.

CONCLUSION

In this review of state and federal law, it is apparent that the duties of the corporate director are broad, varied and, at present, expanding. It is also clear that in many critical areas the duties may be difficult to classify in a structured manner. Unless there is reference to a particular factual situation, a director's exposure can be expressed only in generalities which approach the quality of platitudes. It is interesting to note that the Securities and Exchange Commission has abandoned its recent efforts to develop a set of guidelines on the duties of a director because of a recognition that different types of directors may require different standards of responsibility.¹⁴⁶

The lawyer who is called upon to advise a director of his duties and responsibilities must attempt to identify the most sensitive areas such as; conflict of interest situations, the issuance of securities by the corporation,

144. The court may have had in mind situations involving conflicts of interest.

145. *White v. Abrams*, 495 F.2d at 735-36. The Seventh, Eighth and Tenth Circuits seem to be in a state of flux on the scienter versus flexible standard issue, but they are leaning toward the ruling in *White v. Abrams*. *Kohler v. Kohler Co.*, 319 F.2d 634, 637 (7th Cir. 1963); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Stevens v. Vowell*, 343 F.2d 374 (10th Cir. 1965).

The Fifth and Sixth Circuits are aligned with the Second Circuit. *Sargent v. Genesco, Inc.*, 492 F.2d 750 (5th Cir. 1974); *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970); *SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974).

The Third Circuit admits that it has not faced the scienter versus negligence issue. *Rochez Bros., Inc. v. Rhoades*, 491 F.2d 402 (3d Cir. 1974). Likewise the Fourth Circuit has not addressed the issue directly. *Baumel v. Rosen*, 283 F. Supp. 128, 139 (D.C. Md. 1968), *aff'd in part, rev'd in part*, 412 F.2d 571 (4th Cir. 1968), *cert. denied*, 396 U.S. 1037 (1969).

146. SEC Press Release (Dec. 17, 1974) *supra*, n. 12.

and the trading in the corporation's securities when material information concerning the corporation has not been disclosed.

In the final analysis, the director will have to consider his personal conduct in a myriad of factual situations, guided perhaps by two essential principles—a diligent concern for fairness and loyalty, and a realization that the assets of the corporation belong to the stockholders and not to him.